

**DEPARTMENT OF ADMINISTRATION
GENERAL SERVICES DIVISION
STATE PROCUREMENT BUREAU**

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Questions and Answers on Contract Performance Security
Prepared by the Department of Administration
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1. What is "contract performance security"?

"Contract performance security" is a financial guarantee that is available to the State should a contractor fail to faithfully perform a contract or pay workers, subcontractors or material suppliers who have worked on the contract.

2. Does the State have an option on whether or not to require contract performance security?

For contracts issued under the authority of the Montana Procurement Act, the State has an option on whether or not to require contract performance security. In fact, under section 18-4-312, MCA, the State has three choices to make concerning contract performance security:

- Should contract performance security be required for this contract?
- If so, in what amount?
- And if so, what types of security should be accepted?

For contracts issued for construction projects, contract security equal to at least the contract sum is required for all projects over \$50,000 (Mont. Code Ann. § 18-2-201).

3. What does the contract performance security cover?

Under section 18-4-312(1), MCA, of the Montana Procurement Act, two things are covered by contract performance security:

- the faithful performance of the contract, and
- the payment of all laborers, suppliers, mechanics, and subcontractors.

This means that if a contract is breached, the contract security should cover the additional cost of getting the contract completed by a different contractor and the payment of any outstanding wages or payments owed to workers, subcontractors, or suppliers.

4. What types of security are allowed?

Under the Montana Procurement Act, the following types of security may be accepted by the State: a bond with a licensed surety company; a letter of credit for no more than \$100,000; cash; a cashier's check; certified check; bank money order; certificate of deposit; money market certificate; or bank draft that is drawn on a federally or state chartered bank or savings and loan association or that is drawn and issued by a credit union. Personal checks are not accepted. See section 18-4-312, MCA, for full details. It is important to note that the State is not required to accept all types of security and retains the option of only accepting certain types of security, such as a surety bond.

Please note that any security must be in a form that the State can utilize without any further approval of the contractor. For example, all certificates of deposit must be assigned only to the State of Montana and must not require the signature of the contractor.

5. Is one type of security preferable to another?

Yes! Surety bonds are much more valuable to the State as contract security than other security options (letter of credit, certificates of deposit, etc.) for the following reasons:

- Surety bonds cover *100% of the value* of the contract even if the State only required "25% of the contract value" for instance. On the other hand, letters of credit or certificates of deposit are only for a *specified amount*. If, therefore, the State needs to recover costs due to a breach of contract, the letter of credit will only cover costs up to a certain dollar amount. In contrast, a bond makes the State "whole" and the State will more likely not be left with unpaid costs due to a breach of contract.
- Letters of credit are issued for a particular length of time and could expire before a problem is discovered. In contrast, a surety bond remains in effect until the contract is complete.

Agencies need to be aware that surety bonds are harder for some businesses to obtain and that the cost of the business obtaining the surety bond is typically passed along to the State in the form of higher contract costs.

6. What factors should an agency consider in making a decision on whether contract performance security is required and if so, what type of security should be acceptable?

First, an agency needs to decide if contract performance security should be required based on several factors:

- the nature of the contract
- the potential cost of completing the project if there is a breach of contract
- can the agency afford to self-insure the risk?
- will numerous workers, subcontractors and material suppliers likely be involved?
- can other contract management tools be used to help control any risks in contract performance such as liquidated damages, retainages, deliverables, etc.
- performance history of similar contract endeavors

If a decision is made to require contract security, the next step is to decide what types of contract security instruments should be accepted. Agencies should consider accepting only surety bonds for contract security in the following instances:

- If the contract involves software development;
- If there is a risk that the State would be left with great expense in getting a contract completed in the event of a breach of contract midway through a project;
- The contract involves many workers, subcontractors, or material suppliers that might be left unpaid by the contractor in the event of a breach of contract.

Agencies should consider accepting *all* forms of lawful contract security (surety bonds, letters of credit, money market certificates, certificates of deposit, or cash) in these instances:

- If the risk to the State of a breach of contract is minimal;
- If the costs associated with completing a contract in the event of a breach of contract will not be great; or
- If the contract is for a small dollar amount.

7. Does the State Procurement Bureau have Standard Statements to address situations where an agency might want to limit the types of contract security it requires?

The State Procurement Bureau has two Standard Statements available regarding contract security. One is for the situation where only surety bonds will be permitted (see <http://www.discoveringmontana.com/doa/gsd/css/Resources/Forms.asp> “Contract Performance Security – Surety Bonds”).

A second SPB Standard Statement is available for those instances where contract security will be required, but forms of security other than surety bonds would be acceptable (see <http://www.discoveringmontana.com/doa/gsd/css/Resources/Forms.asp> “Contract Performance Security – All Forms Accepted”).

8. Are there times when contract security should always be required?

Other than in construction contracts, no. Each case must be looked at to determine the State’s monetary risk coupled with the additional costs or inefficiencies of security. If the task is important and risky, an array of incentives, payment timing, retainages and other strategies should be put in place to help insure contract completion, in addition to contract security. The key thing to understand is that we don’t really want damages, we want performance.

9. How much security should be required?

Under the Montana Procurement Act, the State has the option of deciding how much contract performance security to require. The first thing to note is that the courts will not allow the *keeping* of any more security than it takes to make the State “whole.” Security should be no more than the amount the State could possibly lose on a contract. Often the measure of damages is how much it would cost to replace the failed contract with another one and how much it would take to pay off workers and subcontractors if the contractor failed to pay them. However, the amount of damages should be balanced against the risk of a breach of contract versus the increased cost of the contract due to a contractor passing along the costs associated with obtaining the required security.

If there are times within a contract period where more or less is at risk, the requirement can be for differing levels of security. You can also require retainages or pay only after certain mileposts have passed. Coupling liquidated damages with security requires consulting with your legal counsel

because often you forego getting both actual and liquidated damages unless the contract is crafted very carefully.

NOTE CONCERNING CONSTRUCTION CONTRACTS: If the contract in question is for “construction over \$50,000” (as defined in section 18-2-101, MCA), contract security must be required for at least 100% of the value of the contract.

10. What are “liquidated damages” and when should this be required instead of contract performance security?

Where actual damages would be very difficult to determine after a breach of contract, we are allowed to set the presumed amount of actual damages as “liquidated damages.” To do so, you must use your best efforts to determine this amount accurately. This requirement for liquidated damages must be stated in the RFP or IFB document. Once you have agreed to take your damages in this form, you forego actual contract damages even if they are much greater. Be forewarned that the courts tend to frown on the use of liquidated damages (see section 28-2-721, MCA).

To require both liquidated damages and contract performance security, you must be very specific in your contract since they both can’t cover the same thing. Liquidated damages might be for only some types of deliverables and it must be clear that the intent is to not limit other damages, such as payment of workers and subcontractors. If this becomes an issue, see your attorney.

11. What should be done to collect on a surety bond or letter of credit?

First, read your contract on the subject of “notice to cure” provisions. Second, contact your attorney. After consultation with your attorney, contact the surety company or banking institution to inform them of the situation. Be ready to provide extensive documentation concerning the breach of contract and your ensuing damages.

12. What is “notice to cure”?

It is a requirement that the parties give notice to the other when there is a problem. A time to “cure” or fix the problem is usually given. If there is a failure to fix or cure the problem, the parties move to the next level, which will involve collecting on a surety bond or letter of credit in order to complete the project.

Agencies are now required to use the State’s forms for accepting irrevocable letters of credit or surety bonds. These forms do not contain provisions for “notice to cure” requirements. If, however, other forms of bonds or letters of credit were accepted by an agency or are already on file, the documents may contain mandatory “notice to cure” requirements. Be sure to read the fine print of these documents before terminating or threatening to terminate a contract!

NOTE: Be sure to read the contract as soon as any problems develop and certainly before starting to terminate a contract. The contract may have “notice to cure” requirements that have to be met first.

13. What is the difference between a “performance security” or “contract security” and “bid security” or “RFP security”?

“Performance or contract security” typically insures performance of the contract and payment of workers and is usually referred to as “contract security.” “Bid or RFP security” just insures that a bidder or offeror is willing to enter into a contract after award.

14. What is the difference between a “performance, labor and materials bond” (PLM), a “contract bond” and a “payment bond”?

Different terms have been used interchangeably for many years, but the differences need to be paid attention to. “Performance, labor and materials (PLM) bonds” are typically used for construction projects and are referred to in state construction law (Mont. Code Ann. §§ 18-2-201 and 60-2-113). A PLM bond is issued to insure that the contractor and subcontractor labor and material suppliers are paid should the contractor be unable to pay and to cover the cost of completing or “performing” the contract.

A “contract bond” is generally meant to cover the same things as a PLM bond – the faithful performance of the contract and any unpaid wages or invoices left behind due to a breach of contract. Sometimes however, the requirements for a bond are broken out by a “payment bond” which is designed to pay any unpaid wages and invoices, and a “performance bond” which is issued to cover the costs of finishing or “performing” the contract.

Contracts issued under the Montana Procurement Act require a “contract bond” which covers both the unpaid wages and invoices and the faithful performance of the contract.

15. Is the State liable for unpaid wages and invoices left behind by a contractor if we don’t require contract security?

Under state construction law in section 18-2-202, MCA, an agency is considered liable for unpaid workers, material suppliers, and subcontractors if it didn’t require the necessary PLM bond. If construction is not involved, the requirements for “contract security” are governed by the Montana Procurement Act in section 18-4-312, MCA. In this instance, the law permits the agency to decide if security will be required and if so, in what dollar amount. A statement similar to the liability requirement in section 18-2-202, MCA, for construction *does not* exist in the Montana Procurement Act.

16. What does it mean that contract performance security should be “in effect for the entire contract period”?

When you request contract performance security it must be in place for the entire contract term. “Entire contract term” means the initial contract period, *not including possible renewals*. This means that if a contract runs for a three-year period, the contract security has to cover all three years. If a vendor wants to get security for shorter periods there is no guarantee they can get it for later. In essence, the vendor who cannot get security for the entire period has not met the solicitation requirements and may be not considered a “responsible” or “responsive” bidder or offeror as defined in section 18-4-301, MCA.

If your vendors cannot get security for the entire period you may have asked for too much or maybe the vendor, in the financial institution’s mind, has a high risk of failure. If time allows, you might try providing the vendor with a list of other financial institutions that have supplied bonds or letters of credit for similar procurements to other contractors before you move on to the next vendor, or suggest that they contact the federal Small Business Administration “Surety Bond Guarantee Program” at (406) 441-1081 in Helena. On rare occasions, you may be faced with a situation of needing to accept contract security for a time period less than the full contract period. If this is unavoidable, be sure to have language in the contract that requires at least a 90-day notice to you stating that the contractor has obtained security for the following time period. If you don’t receive this assurance of security

coverage, you will need to take steps to terminate the contract and then proceed to solicit a new contractor.

NOTE: Contracts must not be renewed until new or renewed contract security is in place covering the entire period of the renewal.

17. Can contract performance security requirements be altered after the IFB/RFP has been awarded?

No. The State has a duty to award contracts based upon the specifications that were set out. An amendment to specifications before signing a contract should not be allowed.

18. What should we do if a vendor is having a hard time getting contract performance security?

First and foremost, every vendor should have checked out his or her ability to get contract performance security before submitting a bid or offer. Obviously the cost of obtaining security needs to be figured into their submitted prices and we would question the reliability of any company not considering this.

In the event a vendor does discover that they are having difficulty in getting the required security, your agency can assist the vendor in considering other options. Can they go to another bond company or financial institution? Can they put up sufficient collateral to secure a bond or loan? Did they consider putting up personal property as collateral? Have they contacted the federal Small Business Administration "Surety Bond Guaranteed Program"? If all fails, go to the next vendor or cancel and reconsider your specifications before you go out again. Do not risk state resources by waiving a security requirement!

19. Are there any special forms to be used when accepting a surety bond or irrevocable letter of credit?

Yes, pursuant to ARM 2.5.502 the Department of Administration will supply the forms required to submit a surety bond or an irrevocable letter of credit for either contract performance security or for bid/proposal security. These forms can be found at <http://www.discoveringmontana.com/doa/gsd/css/Resources/Forms.asp>. This requirement to use these forms must be included in any solicitation requiring contract performance security or requiring bid/proposal security, unless the State Procurement Bureau approves an alternative form. The specific forms are: "Contract Performance Bond," "Bid or Proposal Bond," and "Irrevocable Letter of Credit."

20. What if there is a conflict between the language in a bond and the requirements of an RFP?

The State now requires that contractors use the State's Contract Performance Bond form or Irrevocable Letter of Credit form to submit bonds or letters of credit as security. Before an RFP is drafted, be sure that nothing in the RFP conflicts with the required forms.

21. What is the approximate cost of a vendor obtaining a bond for \$100,000 for instance?

Bonds are like insurance. It depends on the level of risk of the activity, the soundness of the insured and the knowledge of the insurer. The cost of a bond for \$100,000 can range from \$250 to \$10,000.

“Prime clients” may be required to only pay \$250 per \$100,000, while a “weak company” in the eyes of the surety company, will be charged the higher rates in order to be comfortable in providing the risk.

Where there are renewal periods, each extension should be treated as a new bond with a new cost by the bonding company. Sometimes the total cost of a bond may increase if there are renewals based on other agreed to formulas.

Sometimes a potential contractor will overstate the importance of this cost in order to test your resolve in requiring a certain amount. Or sometimes, a vendor may have a business history that is uninsurable and clearly the State should not be contracting with them. At other times, however, the security requirements may make a project unreachable for small businesses and the State should consider this and examine the risks associated with a specific project before setting a required security amount.

22. What is the difference between “contract performance security” and general liability insurance?

“Contract performance security” is a bond that insures that the vendor will carry out its part of the contract. “Liability insurance” is insurance that covers an array of personal and property damages the vendor may cause to others, including the State, while carrying out their part of the contract. Liability insurance does not cover a breach of contract.

23. Under the Montana Procurement Act, section 18-4-312(2)(b), MCA, states that Irrevocable Letters of Credit cannot exceed \$100,000. Can a contractor provide multiple letters of credit in order to reach the required level of security?

Yes, but only as long as they are from different financial institutions.

24. Are there major pitfalls concerning contract performance security?

Yes! First, understand that bonding companies are not in business to pay you. They plan on keeping their money. You may well have to litigate with the bonding company and the contractor who has somehow breached the contract to recover any of your costs. Remember, contract performance security is not a “fine,” but rather a way to recover the expenses of a getting a new contract in place if the first one fails and paying unpaid workers, subcontractors or material suppliers.

Unfortunately, sometimes even if the State does have the right to recover some costs, the vendor may already be bankrupt. Expect claims on any money from everywhere – the federal government, other state governments, creditors, laborers and material suppliers. All will be claiming some sort of priority and it may take years to clear up.

Second, one key to a successful project is developing specifications and evaluation factors that lead to a qualified vendor in the first place. Another crucial key for the State is contract monitoring. Agencies must be prepared to devote the resources necessary to monitor the contract to assure that performance standards are met so we don’t have to ever claim any security.